APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 16335

FRUEHAUF CORPORATION, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

On Petition for Review of a Decision of the Tax Court.

Decided March 10, 1966.

Before: PHILLIPS, Circuit Judge, CECIL, Senior Circuit Judge, and KENT, District Judge.

CECIL, Senior Circuit Judge. The sole question presented on this petition for review of a decision of the Tax Court is whether an order of the Commissioner, changing the petitioner's method of inventorying used trailers, made in 1959, can be retroactive to the petitioner's tax years 1954, 1955 and 1956. The Tax Court decided the issue adversely to the petitioner.

The facts are fully stated in the Findings of Facts and Opinion of the Tax Court. 42 T.C. 83. The pertinent facts are not in dispute. We restate here only such facts as demonstrate the question involved. The petitioner, Fruehauf Trailer Company, began acquiring used trailers about the year 1926. These used trailers were inventoried by the petitioner at one dollar per unit. This practice was not questioned by the Commissioner for the years prior to 1942. The Internal Revenue Service had examined and audited the petitioner's federal income tax returns for the years prior to 1942, and had made no change with respect to the method of inventorying used trailers. The method was questioned in the examination of the 1939 return but nothing was done about it.

On April 28, 1948, the petitioner received the revenue agent's report of March 15, 1948, for the four years 1942 through 1945. In this report the agent proposed to adjust the used-trailer inventory at December 31, 1945, from one dollar per unit to the lower of cost or market. The petitioner protested this change. It was argued on behalf of the petitioner that the one dollar per unit should be continued, but that if the change was made for December 31, 1945, similar adjustments should be made for the opening and closing inventories for the four years 1942 through 1945. At a conference at the Detroit office of the Internal Revenue agent, in September 1948, a tentative agreement was made to revise the inventories for the four years in question, on the lower of cost or market method.

The petitioner executed a Form 874 on November 9, 1948, agreeing to the deficiency for the four years in question. On February 11, 1949, petitioner was notified by the Detroit office that the case would be disposed of in accordance with the agreement evidenced by Form 874. The petitioner paid the assessment on June 8, 1949. The Commissioner never certified the over-assessments as set forth on Form 874.

As of January 1, 1949, partly because petitioner thought the inventory issue was settled, in accordance with Form 874, and partly in the interest of more accurate reporting of annual earnings, petitioner changed, on its books, its method of inventorying used trailers to the lower of cost or market.

It was necessary that the agreement of November 9, 1948, as evidenced by Form 874, be approved by the national office of the Internal Revenue Service. On March 7, 1950, the office of the Chief Counsel returned to the Income Tax Unit in Washington the administrative file for the years 1940 through 1945, for reconsideration of the proposed revision of the used-trailer inventory. The 1940 and 1941 years came under consideration by reason of an allowance of petitioner's claims in part by the Excess Profits

Tax Council. It was stated in the memorandum of the Chief Counsel's office, that,

> "While taxpayer's method of computing inventories of used trailers is obviously erroneous, it is the opinion of this office that a correction should not be made in this case in a manner that will result in the substantial benefit to the taxpayers as now proposed. * * * Unless a settlement on a more equitable basis can be reached or the correction made starting in a year where the opening inventory is small and the double benefit would not be so great (as, for instance, the year 1944), it is the opinion of this office that the Government should refuse to permit a change in the erroneous method of inventorying used trailers used by the taxpayer."

Negotiations between representatives of the petitioner and representatives of the Detroit office and the national office of Internal Revenue Service failed to reach any agreement for the settlement of the inventory issue.

On June 20, 1950, the Deputy Commissioner of Internal Revenue addressed a letter to the internal revenue agent in charge in Detroit which stated in part:

> "The taxpayer's representatives have not made an acceptable offer whereby the double deduction created by the opening inventory for 1942, could be compensated on an equitable basis, but have indicated that recomputation of the inventories on the dollar value basis, heretofore consistently followed by the taxpayer, would be satisfactory."

Following this, on June 23, 1950, the chief conferee of the Detroit office advised a representative of the petitioner that it had been decided to accept petitioner's used-trailer inventory of one dollar per unit. It was then agreed that recomputations would be made for the years 1940 through

1945 on the basis of one dollar per unit inventory. A revised form 874 was executed to this effect on July 5, 1950, and on July 7, 1950, the petitioner was advised through the Detroit office that the case would be disposed of in accordance with the recomputation. On November 15, 1950, petitioner received a refund of $1,503,230.81 in federal income and excess profits taxes (including interest) for the years 1940 through 1945, in accordance with the recomputations agreed to in Form 874 dated July 5, 1950. This restored the petitioner to the dollar per unit method of inventory.

In the meantime, after the tentative agreement of September 10, 1948, but before June 20, 1950, petitioner filed a claim for refund for 1946, an amended return for 1947, and an original return for 1948, all based on the inventorying of used trailers at the lower of cost or market. The Commissioner rejected the claim for refund on the 1946 return on January 28, 1953. He rejected the amended return for 1947, and the 1948 return was recomputed on the basis of inventorying used trailers at one dollar per unit. This action was taken in accordance with the agreement reflected in Form 874, dated July 5, 1950. In 1949 and thereafter, the petitioner filed its returns with its inventory of used trailers at one dollar per unit. The petitioner's returns for the years 1949 through 1953 were examined by a revenue agent and, while the one dollar per unit practice was questioned, it was not disturbed.

> "On March 31, 1959, the revenue agent informed petitioner that the national office of the Internal Revenue Service had decided that it could no longer go along with petitioner's practice of inventorying its used trailers and that, beginning with the trailers acquired during 1954 the inventory would have to be computed on the lower of cost or market basis. Thereafter, on April 28, 1960, and August 29, 1960, the deficiency notices which form the basis for this proceeding

were issued." Findings of Fact, Tax Court. 42 T.C. 83, 94.

In this Court, it is conceded that the Commissioner could make the change prospectively, in the method of reporting the petitioner's inventory of used trailers. It is argued that the change cannot be made retroactive to the years 1954, 1955 and 1956.

The petitioner, on the issue now before us, argued in the Tax Court that it was an abuse of discretion on the part of the Commissioner to apply the order of March 1959, changing the method of inventory, retroactively. The Tax Court decided against the petitioner on the question of abuse of discretion. It found that "Respondent was not precluded in 1959 from making the change beginning with the then open years 1954, 1955 and 1956." The claim of abuse of discretion is abandoned and is not presented to our Court on this review.

It is now claimed that the decision of the Commissioner, in 1950, to continue the petitioner's one dollar per unit method of inventorying used trailers, had the force of legislation and could not be applied retroactively. In support of this claim, it is argued that the Commissioner is given a broad discretion under Section 446(a) and (b) Title 26, U.S.C., to make a computation of income which, in his opinion, clearly reflects income, that his exercise of that discretion in 1950 was legislative in nature and that the Commissioner could not subsequently retroactively reverse legislative action.

We cannot accept the theory that the Commissioner's decision in 1950 to permit the petitioner to continue a method of inventorying used trailers which was obviously erroneous was legislative in character.

As said by the Supreme Court in *Dixon* v. *United States*, 381 U.S. 68, 72:

> In *Automobile Club of Michigan* v. *Commissioner*, *supra*, 183-184, we held that the Commissioner is empowered retroactively to correct mistakes of law in the application of the tax laws to particular transactions. He may do so even where a taxpayer may have relied to his detriment on the Commissioner's mistake. See *Manhattan General Equipment Co.* v. *Commissioner*, 297 U.S. 129. This principle is no more than a reflection of the fact that Congress, not the Commissioner, prescribes the tax laws. The Commissioner's rulings have only such force as Congress chooses to give them, and Congress has not given them the force of law. Consequently it would appear that the Commissioner's acquiescence in an erroneous decision, published as a ruling, cannot in and of itself bar the United States from collecting a tax otherwise lawfully due."

The principal authority cited in support of petitioner's theory is *Arizona Grocery* v. *Atchison Ry.*, 284 U.S. 370. In this case there was an order of the Interstate Commerce Commission fixing freight rates in accordance with the statute[1] giving it the power to fix rates. It was a general order affecting all railroads operating between the points involved. Later, after the Commission found that the rate was unreasonable, it fixed a new lower rate and made it retroactive. The Court held that the Commission could make the new rate applicable to the future but could not make it retroactive. This is not analogous to the case before us.

It is not necessary in this opinion to engage in a discussion of so-called "legislative rules" and "interpretative rules" or the distinction between these terms. As to this distinction, Professor Davis in his *Administrative Law Treatise*, Vol. 1, § 5.03, p. 298 (1958), says:

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[1] Sec. 418-421, 41 Stat. 484-488.

> "Yet we have the benefit of only occasional judicial explanation of the distinction, and the Supreme Court apparently has never provided a full-bodied discussion of it. Indeed, the term 'legislative rule' or 'legislative regulation' apparently does not appear in any Supreme Court opinion."

In the case before us we have a decision of the Commissioner affecting the inventory of one individual company. The decision does not involve a change in the law nor any change in the regulations. The Commissioner has simply interpreted existing law by correcting an erroneous method in the taxpayer's practice of inventorying used trailers.

In this connection the Tax Court said:

> "It was a mistake of law for the respondent to permit petitioner to continue to inventory its used trailers at $1 each after about 1942 when both petitioner and respondent were satisfied that is was obviously erroneous to pursue such a practice, because such practice was contrary to the respondent's regulations. See Regulations 111, section 29.22(c)-2, and Regulations 118, section 39.22(c)-2, both of which provide that 'Taking * * * the inventory, at a nominal price or at less than its proper value' was not in accord with the regulations. See also *Dobson* v. *Commissioner*, 320 U.S. 489, wherein the Supreme Court has held it to be 'a clear-cut question of law' where 'applicable statutes and regulations properly interpreted forbid' a method of calculation, such as the taking of inventories in the instant case at the nominal price of $1 per unit."

Counsel for the petitioner have based their claim for reversal of the decision of the Tax Court squarely on the theory that the 1950 decision of the Commissioner was legislative in character and that it cannot be reversed retroactively. Not one authority, analogous to the case at bar, has been cited to us, nor have we found any that

supports this theory. Cases,[2] other than those decided on the legislative theory, are cited where the Commissioner was not permitted to change a former ruling or to apply it retroactively but those cases were decided on the particular facts of each case.

Throughout the argument of counsel for the Commissioner the tax years in question, 1954-1956, are referred to as open years, that is, assessment for those years is not barred by the statute of limitations. No explanation is given as to what statute is involved or how it is applicable to the facts of this case. We presume the statute is Section 6501(e)(1)(A), Title 26, U.S.C. Neither the petitioner nor the Tax Court raise any question about the years under consideration being barred by the statute of limitations, so we treat them as open years as claimed by the Commissioner.

Since the only claim of the petitioner, based on the legislative theory fails, we must conclude that the finding and decision of the Tax Court is correct. The Tax Court found that "Respondent was not precluded from making the change beginning with the open years 1954, 1955 and 1956," and that he was not estopped from doing so by his prior actions.

The Internal Revenue Code of 1954 provides that "The Secretray or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect." 26 U.S.C. § 7805(b). The Tax Court held that the Commissioner did not abuse his discretion in his retroactive ruling in the present case.

Finding no error of law in the decision of the Tax Court, it is affirmed.

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[2] *Maloney* v. *Hammond*, 176 F. 2d 780, C.A. 9; *H. S. D. Co.* v. *Kavanagh*, 191 F. 2d 831, C.A. 6; *Woodworth* v. *Kales*, 26 F. 2d 178, C.A. 6.

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Before: PHILLIPS, Circuit Judge, CECIL, Senior Circuit Judge, and KENT, District Judge.

On Petition to Review a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed.

No costs awarded. Rule 23(4).

Entered by order of the Court.

CARL W. REUSS
Clerk

(Filed Mar. 10, 1966, Clark W. Reuss, Clerk)

APPENDIX B

Internal Revenue Code of 1939:

Sec. 22. GROSS INCOME.

* * * * * * * * * * *

(c) INVENTORIES.—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Sec. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

For use of inventories, see section 22(c).

Treasury Regulations 111 on Income Tax (1939 Code):

§ 29.22 (c)-1 Need of inventories.—

In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary

in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold (including containers), title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased (including containers), title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected. (But see § 29.22(d)-1.)

§ 29.22 (c)-2 Valuation of inventories.—

Section 22(c) provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

It follows, therefore, that inventory rules can not be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to

be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with these regulations. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

* * * * * * * * * * *

The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with these regulations, viz:

(1) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.

(2) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.

(3) Omitting portions of the stock on hand.

(4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock.

(5) Including stock in transit, shipped either to or from the taxpayer, the title to which is not vested in the taxpayer.

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§ 29.41-1 Computation of net income.—

Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's

income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See §§ 29.42-1 to 29.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

§ 29.41-2. Bases of computation and changes in accounting methods

Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See §§ 29.42-2 and 29.42-3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see § 29.22 (c)-5.)

* * * * * * * * * *

A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. For the purposes of this section, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see §§ 29.22(c)-1 to 29.22(c)-8, inclusive); a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long-term contract method from the percentage of completion basis to the completed contract basis, or vice versa (see § 29.42-4); or a change involving the adoption of, or a change in the use of, any other specialized basis of computing net income such as the crop basis (see §§ 29.22(a)-7 and 29.23(a)-11). * * * Permission to change the method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms and conditions under which the change will be effected. * * *